

BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

April 4, 2002

IN RE:

**RECONSIDERATION OF THE
REQUIREMENTS ON LOCAL
EXCHANGE COMPANIES
ADOPTED IN DOCKET U-87-7492**

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**DOCKET NO.
01-00799**

ORDER

This matter came before the Tennessee Regulatory Authority ("Authority") at the regularly scheduled Authority Conference held on November 6, 2001, pursuant to the *Notice of Filing* issued on September 27, 2001 relative to the Authority's reconsideration of the requirements on local exchange companies adopted in Docket U-87-7492.

TRAVEL OF THE CASE

At the September 25, 2001 Authority Conference, the Authority requested, *sua sponte*, that interested parties file comments as to whether local exchange companies ("LECs") should continue adjusting access rates in accordance with the provisions established in 1988 by the Tennessee Public Service Commission ("TPSC") in Docket U-87-7492.¹ On September 27, 2001, the Authority memorialized this request by sending a *Notice of Filing* to all incumbent LECs and interexchange companies ("IXCs") operating in Tennessee. The Authority received comments from all incumbent LECs and one IXC.

¹ In re: Tariff Filing by AT&T Communications to Establish Rates and Charges For Megacom and Megacom 800 Services, No. U-87-7492 (Tennessee Public Service Commission, March 17, 1988). The Order resulting from this docket is commonly, and hereinafter, referred to as the "Megacom Order".

All comments filed in this proceeding support the termination of these requirements. Specific comments will be addressed later in this Order.

Summary of the Megacom Docket

In 1988, the TPSC consolidated into Docket U-87-7492 several similar tariffs filed by AT&T, MCI and Sprint for investigation and hearing. The tariffs in question all proposed to offer new services which were designed to bypass the local exchange network and, therefore, preclude the IXCs from having to pay switched access charges to the LECs. By circumventing these access charges, the petitioners contended that they could offer service to high volume customers at substantially reduced rates.

In order to bypass the local exchange network, subscribers could build their own link to the IXC switch, such as a microwave system, or as in most instances purchase a dedicated special access facility from the customer premise to the IXC switch. Although initially expensive to install, these dedicated facilities provided savings to customers in the long run by allowing customers to complete all calls over the same facility at a much lower per-minute rate. Furthermore, the proposed services offered convenience by providing customers with the ability to choose one carrier to handle all long distance calls, including intraLATA traffic that IXCs had previously been prohibited from carrying.

These new IXC services posed two fundamental concerns to the TPSC. First, the services meant that toll calls bypass the local network, thus eliminating switched access payments from IXCs, which were relied on by LECs for substantial contribution to network costs. Second, since the proposed services intruded into the intraLATA market, the existing level of toll revenues received by LECs would be threatened, thereby potentially placing upward pressure on local rates.

Despite the aforementioned concerns, the TPSC approved the tariffs filed by AT&T, MCI and Sprint based on the reduction in toll rates, the higher quality of service provided to large business customers and the convenience of one-stop shopping. Approval, however, was granted subject to certain conditions. AT&T, MCI and Sprint were allowed to market and provide the proposed services on a statewide basis, but were prevented from pricing the intraLATA portion of their proposed services below the average WATS rate for a LEC-provided intraLATA call. The TPSC found that this requirement would minimize the competitive pressure and the resulting impact on LECs. Without this requirement, IXCs could price their intraLATA toll far below the LEC toll rate, thus causing financial harm to the LECs. The TPSC, however, reaffirmed its position that intraLATA competition, other than the services approved in this docket, should be prohibited due to obvious public interest concerns.

The TPSC imposed additional conditions aimed at ensuring that the new services did not provide lower toll rates to large business customers at the expense of local ratepayers. The TPSC utilized its existing intraLATA compensation arrangement in requiring IXCs to pay compensation on all intraLATA calls completed using the proposed services regardless of whether the call was carried over a special access or other bypass facility. The compensation rate was calculated by adding the originating and terminating switched access rates that the IXC would have paid for an interLATA call; the TPSC had previously determined that this level of compensation approximately reimbursed the LECs for their lost toll revenue. The TPSC also ordered the IXCs to pay tariffed access charges on interLATA calls, regardless of whether the calls were placed via the switched network or completed through the IXC's own network.

In essence, the TPSC required the aforementioned intraLATA compensation and payment of interLATA access charges to ensure that IXC's continued providing a contribution to local networks. The TPSC recognized, however, that interLATA toll usage was increasing at a far greater rate (12% - 15% per annum) than the total number of local subscribers (3.5% - 4%). Accordingly, IXC's were paying an increasingly larger portion of the total amount necessary to cover the network costs. Therefore, local rates might continue to decline, but would do so only at the expense of long distance consumers. To address the bypass issue and prevent the gradual shifting of costs from local to long distance customers, AT&T proposed that access fees be collected as a flat fee per access line regardless of any change in access minutes used.

Through negotiations of the parties, including the TPSC Staff, the TPSC adopted a plan whereby each LEC was required to adjust annually its carrier common line charge ("CCLC") rate in order to maintain a fixed amount of access revenue per access line. Each LEC was required to reduce its CCLC rate by the amount that its access minutes of use ("MOU") growth rate exceeded its growth rate in access lines. This required adjustment recognized that access charges should continue to be levied on a per minute basis, yet prevented IXC's from paying an increasing amount of total telephone costs.

Inapplicability of the Megacom Order to Price Regulated Companies

On December 31, 1997, United Telephone-Southeast ("UTSE") filed a petition (Docket No. 97-07628) for a declaratory ruling pursuant to Tenn. Code Ann. § 4-5-223(a) regarding the validity or applicability of the Megacom Order to UTSE as a price regulated company. BellSouth was granted intervention in the proceeding and supported UTSE's position. The prime issue of the case was whether UTSE should be required to continue

adjusting access rates under the requirements of the Megacom Order given that the company's rates were now governed by the price regulation statutes, specifically Tenn. Code Ann. § 65-5-209. UTSE argued that while the Megacom Order requires annual adjustments to access rates, the more recently enacted price regulation statutes classify access services as non-basic services for which a qualified company can set rates as it deems appropriate under Tenn. Code Ann. § 65-5-209.² UTSE also argued that one of the fundamental principles underlying the Megacom Order – the prohibition against intraLATA competition – had been superseded because the TRA had ordered the implementation of toll dialing parity.

In its *Declaratory Order* dated November 24, 1998, the Authority granted UTSE's petition based upon the following findings. First, switched access services are specifically included in the definition of interconnection services as provided in Tenn. Code Ann. § 65-4-101(f). Furthermore, UTSE is permitted to annually adjust the rates for interconnection services based on the indexing methodology contained in Tenn. Code Ann. § 65-5-209(g) and (h). The Authority found that these statutory provisions superseded the annual access adjustments required by the Megacom Order. The Authority also recognized that restrictions prohibiting intraLATA competition had been lifted, thus eliminating a fundamental basis for the required access adjustments set forth in the Megacom Order.

On November 19, 1998, Citizens Telecommunications Company of Tennessee ("Citizens") filed a petition with the Authority seeking a determination on the applicability of the Megacom Order. Citizens, a price regulated company, set forth arguments identical to those previously asserted by UTSE. On June 2, 1999, the Authority issued an order

² "Incumbent local exchange telephone companies subject to price regulation may set rates for non-basic services as the company deems appropriate..." Tenn. Code Ann. § 65-5-209(h)

eliminating the Megacom access adjustments for Citizens on the same bases that were established for UTSE.

On October 1, 1998, BellSouth submitted its annual access adjustment as required by the Megacom Order, and on October 27, 1998, the Authority approved BellSouth's Price Regulation Plan. On November 19, 1998, BellSouth filed a letter with the Authority referencing the *Declaratory Order* from Docket 97-07628 in which the Authority determined that the price regulation statutes superseded the requirements of the Megacom Order. BellSouth, as a price-regulated company, then withdrew that portion of its access tariff that was filed to comply with the Megacom Order.³

THE INSTANT DOCKET

Positions of the Parties

Pursuant to the *Notice of Filing*, on October 17, 2001, the Tennessee Small Local Exchange Coalition ("Coalition") filed comments on behalf of its fourteen member companies.⁴ The Coalition contends that the many changes in the telecommunications industry since the Megacom Order make the adjustments unnecessary. First, citing page 16 of the Megacom Order, the Coalition states that the concern over long distance customers paying "an increasingly larger share of the total costs of telephone service" has been alleviated due to the access reductions that have occurred since 1988. Furthermore, the Coalition states that any additional access reductions could jeopardize the existing contribution received from access services to support local exchange services. Finally, the

³ The annual adjustment for recovering costs to operate the dual party relay system remained in the tariff.

⁴ These companies include Ardmore, Century of Adamsville, Century of Claiborne, Century of Ooltewah-Collegedale, Concord, Crockett, Humphreys County, Loretto, Peoples, Tellico, Tennessee, United and West Tennessee Telephone Companies.

Coalition states that proposed changes to the system of access rates or cost recovery should not be addressed in this docket, but rather in the Authority's pending dockets regarding universal service and access charge reform.

Comments filed on October 17, 2001 by Citizens Telecommunications Company of Tennessee and Citizens Telecommunications Company of the Volunteer State ("Citizens") state that the Megacom requirements should be discontinued because the policy rationale underlying the Megacom Order no longer exists. First, Citizens states that the primary basis of the Megacom Order, the prohibition against intraLATA competition, has been removed. Citizens also states that the requirements set forth in the Megacom Order were aimed at reducing the level of access charges. Notwithstanding this comment, Citizens of the Volunteer State could have increased access rates for the past two years pursuant to the Megacom requirements,⁵ although it has chosen not to increase its access rates. Finally, Citizens asserts that if the Authority considers adjusting access charges, it should consider aspects such as incumbent LEC costs, the value of subsidies provided by access services, the degree of toll competition and whether such competition is hindered by the level of access charges.

In its October 17, 2001 filing, AT&T comments that the basis for the Megacom access adjustments no longer exists and that continued application yields unjust, unreasonable and discriminatory CCLC rates, especially for those incumbent LECs that are increasing rates pursuant to the requirements of the Megacom Order. AT&T asserts that the Megacom access adjustments were never intended to be long-term, but rather an interim system imposed to allow IXC's to offer certain services. AT&T contends that the

⁵ Citizens Telecommunications of Tennessee is not required to file access adjustments pursuant to the Megacom Order because it is a price regulated company.

Megacom access adjustments were developed without review of incumbent LEC cost or revenue needs, and therefore, represent the value of service pricing. AT&T elaborates that absent a determination of the specific revenue needs or costs of providing access services, the continued obligation for IXC's to pay such contribution via access charges is purely arbitrary. AT&T concludes its comments by stating that (1) the current level of access charges should be replaced with a cost-based system for each incumbent LEC operating under rate-of-return regulation, and (2) the ultimate determination for proper levels of access charges includes issues to be determined in other proceedings before the Authority, such as the universal service and the access charge reform dockets.

Applicability of the Megacom Order to Rate-of-Return Companies

The Megacom Order requirements have remained in effect for the rate-of-return ("ROR") regulated incumbent LECs operating under the Authority's jurisdiction.⁶ The present question before the Authority, therefore, is whether to continue the Megacom access adjustments for ROR regulated incumbent LECs. Since the inception of the Megacom Order, market conditions and underlying principles that the Order was based upon have changed dramatically, and in some circumstances, no longer exist. These changes, along with universal service concerns and recent legislation enacted by the General Assembly, make a case for the elimination of the LEC annual access charge adjustments required by the Megacom Order.

In the Megacom Order, intraLATA competition was prohibited in an effort to preserve contributions received by local exchange companies from toll and access services.

⁶ These companies include Ardmore, Century of Adamsville, Century of Claiborne, Century of Ooltewah-Collegedale, Citizens of the Volunteer State, Concord, Crockett, Humphreys County, Loretto, Millington, Peoples, Tellico, Tennessee, United and West Tennessee Telephone Companies.

These revenue streams were necessary to maintain affordable local residential service rates; consequently, without these revenue sources there could be upward pressure on local rates. In 1996, however, intraLATA toll dialing parity was mandated by the FCC, which initiated competition for LEC intraLATA toll revenues. With the further introduction of competition in local markets, LEC local revenues are at risk.

The requirements of the Megacom Order generally serve as a mechanism to reduce LEC access revenues. Any revenue reduction for LECs operating under ROR regulation in the developing competitive environment brings universal service concerns to the forefront. These access reductions, together with the advance of competition into areas served by LECs, has the potential to create upward pressure on local rates. While the Authority has responded by establishing dockets to address universal service issues for all telephone companies, annual Megacom rate adjustments that result in overall revenue reductions for LECs should not continue if they could potentially impact the affordability of local rates.

In its comments, AT&T argues that the Megacom adjustment has allowed some incumbent LECs to increase their access rates, at the expense of the IXC's. While it is true that some incumbent LECs have slightly increased access rates in certain years, the overall access adjustments resulting from Megacom have significantly reduced access rates since 1988.⁷

Moreover, the TPSC, in approving the mechanism to reduce access charges, stated a goal of "keeping intrastate toll rates at a reasonable level." At the time that the Megacom adjustments were ordered, IXC's were required to flow-through a significant portion of access cost savings to their customers in the form of lower long distance rates. Therefore,

⁷ Last year's Megacom adjustment resulted in incumbent LEC's access charges being reduced by \$170,000.

there was a consumer benefit of reducing LEC access charges. This requirement, along with the cap on DDD rates, helped ensure that Tennessee consumers received affordable long distance rates.

Telecommunications regulation has dramatically changed in this area. Legislation recently enacted by the Tennessee General Assembly grants IXC's the ability to increase long distance rates, including those previously capped; IXC's no longer have to pass on access cost savings to consumers. Accordingly, the mechanism adopted in the Megacom docket to help ensure the continuing affordability of long distance rates (i.e., reduced access charges), has been rendered ineffective since IXC's now have the flexibility to establish rates as they deem appropriate.

The TPSC also found that the access charge system was "gradually forcing long distance customers to pay an increasingly larger share of the total costs of telephone service." IXC toll MOU in 1988 were growing at 12% - 15% annually, while access line rates were growing at 3.5% - 4%. Accordingly, the TPSC found that local rates might continue to decline, but would do so only at the expense of long distance consumers. So the TPSC created a mechanism to reduce CCLCs, a component of access fees, by the amount that interLATA MOU exceeded access line growth. This allowed IXC's to benefit more from growth in their market, while allowing LEC's to continue receiving a constant revenue per line from access charges. Because the difference in access line growth and growth in access minutes has narrowed significantly, and since rates for access charges have decreased dramatically for all LEC's since 1988, it is difficult to argue that, absent Megacom, IXC's will pay an increasingly larger portion of telephone costs. Thus, one of the principles for which Megacom requirements were established is no longer supported.

FINDINGS AND CONCLUSIONS

The Authority has previously determined that the price regulation statutes supersede the requirements of the Megacom Order and, therefore, the price regulated local exchange companies (BellSouth, Sprint-United and Citizens of Tennessee) are no longer required to adjust their access rates in accordance with the Megacom Order. The Megacom requirements, however, have remained in effect for the rate-of-return incumbent LECs under the Authority's jurisdiction.

In the Megacom Order, the TPSC established policies relating to intraLATA competition, long distance rates, and access charges. The TPSC prohibited intraLATA competition and found that "in order to maintain the IXC's contribution to the local network while keeping the intrastate toll rates at a reasonable level," access charges would be adjusted annually to maintain a fixed revenue per line.⁸ IXCs, in turn, would reduce their toll rates to reflect the access savings. Many of the underlying principles set forth in the Megacom Order, however, no longer exist. The prohibition against intraLATA competition has been lifted and IXCs are no longer required to reduce their rates as a result of any access savings realized.

Furthermore, access adjustments resulting from the Megacom Order add pressure on local rates in light of today's evolving competitive environment, thus creating universal service concerns. Continuing the requirements adopted in the Megacom Order would have the overall effect of reducing revenues for LECs, thus placing upward pressure on local rates. At the same time, IXCs would receive cost reductions in the form of lower access fees, yet long distance consumers would have no assurance of receiving any corresponding

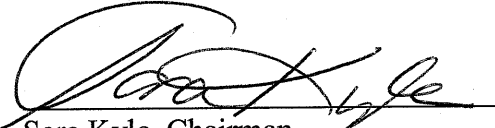
⁸ Maintaining a fixed revenue per line was necessary to preserve existing contributions provided by access charges, yet prevent IXCs from paying an increasingly larger portion of network costs via access charges.

rate reductions. The immediate effect of continuing the access adjustments would be to reduce LEC revenue – revenue which is needed to support the local network.


The Authority concludes that continuing the requirements adopted in the Megacom Order would result in the reduction of revenues for LECs and place upward pressure on local rates. IXCs would receive cost reductions in the form of lower access fees, yet IXC consumers would have no assurance of receiving any corresponding rate reductions. Therefore, at the November 6, 2001 Authority Conference, the Directors unanimously voted to terminate the annual access charge adjustments established in the TPSC's 1988 Megacom Order.

IT IS THEREFORE ORDERED THAT:

The provisions established in Docket U-87-7492 that require local exchange companies to adjust annually their carrier common line charges (CCLC) are hereby terminated.


Sara Kyle, Chairman
H. Lynn Greer, Jr., Director
Melvin J. Malone, Director

ATTEST:


K. David Waddell, Executive Secretary